Supreme Court, U.S.
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No.

In the Supreme Court of the United States

OCTOBER TERM, 1996

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

TEXACO, INC. AND SUBSIDIARIES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

WALTER DELLINGER
Acting Solicitor General
LORETTA C. ARGRETT
Assistant Attorney General
LAWRENCE G. WALLACE
Deputy Solicitor General
KENT L. JONES
Assistant to the Solicitor General
JONATHAN S. COHEN
THOMAS J. CLARK
Attorneys
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTION PRESENTED

Whether a directive of a foreign government that has the ancillary consequence of distorting the income of a United States taxpayer—by causing profits earned by the activities of that taxpayer to be realized instead by its foreign affiliates—prohibits the Commissioner of Internal Revenue from exercising the power vested in her by statute to apportion or allocate gross income among the affiliates of United States taxpayers "in order to prevent evasion of taxes or clearly to reflect the[ir] income" (26 U.S.C. 482).

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PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-13a) is reported at 98 F.3d 825. The opinion of the Tax Court (App. 14a-187a) is reported at 66 T.C.M. (CCH) 1707.

JURISDICTION

The judgment of the court of appeals was entered on October 17, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE AND REGULATIONS INVOLVED

1. Section 482 of the Internal Revenue Code, 26 U.S.C. 482, provides in relevant part:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. * * *

2. During the years relevant to this litigation, Section 1.482-1A(b)(1) of the Treasury Regulations on Income Tax, 26 C.F.R. 1.482-1A(b)(1) (1981), provided:[1]

> The purpose of section 482 [of the Internal Revenue Code] is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so

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[1] The provisions of this regulation have been placed in a different format in the regulation that replaced it for tax years beginning after April 21, 1993. Compare 26 C.F.R. 1.482-1T(a) and (b), with 26 C.F.R. 1.482-1A(b). The newer regulation does not alter the provisions of relevance to this case.

to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

STATEMENT

1. a. In 1933, the government of Saudi Arabia granted a concession to Standard Oil of California to explore for, extract and export Saudi Arabian oil (App. 18a). A corporation known as Aramco (the Arabian American Oil Company) was formed to exercise the rights granted under that concession. Since 1948, that corporation has had the same four shareholders—Standard Oil of California (now Chevron), Standard Oil of New Jersey (now Exxon Corporation), Socony-Vacuum Oil Company (now Mobil Corporation) and Texaco (*id.* at 19a). Texaco (along with its consolidated subsidiaries) is the respondent in this case.

Under the terms of the Saudi concession, the right of Aramco to extract oil was subject to the payment of taxes and royalties to Saudi Arabia (App. 18a-19a). Until 1960, the Aramco participants had effective

control over the production and pricing of Saudi crude oil (*id.* at 28a). Between the time that the Organization of Petroleum Exporting Countries (OPEC) was formed in 1960 and the onset of what has been called the "first oil crisis" in 1973, however, the balance of economic power in this relationship shifted (*id.* at 29a-33a). Saudi Arabia and other oil producing countries gained significant power in establishing production rates and in setting the price for oil in world markets (*ibid.*).

One of the consequences of this evolution in market power was the ability of Saudi Arabia to negotiate concessions from the Aramco participants. One of those concessions was an agreement made in late 1976 that allowed Saudi Arabia to assume 100 percent ownership of the oil producing properties and assets of Aramco. Under this agreement, the four Aramco participants thereafter provided services to Saudi Arabia's oil operations in return for stated fees (App. 33a).[2] In addition, Aramco (along with a Saudi company named Petromin) continued to conduct the world-wide marketing of Saudi crude (*id.* at 32a-33a).

What has been called the "second oil crisis" began in late 1978 when, as a consequence of the Iranian revolution, various oil supplies were removed from the world market. A perceived oil shortage resulted (App. 40a). Dramatic price increases were adopted by OPEC, but not all of its members agreed on the new,

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[2] Although this agreement was not signed (App. 33a), the parties have operated under the terms of the agreement since its negotiation. In particular, Saudi Arabia has assumed ownership of the oil producing assets of Aramco and Aramco has performed service functions under the provisions of the agreement (*ibid.*).

radically higher price structure. In particular, Saudi Arabia sought somewhat smaller price increases than OPEC and declined to adhere to the higher OPEC price. By early 1979, a tiered price structure existed on world oil markets in which Saudi Arabia priced its crude oil somewhat below the price demanded by other OPEC countries (*id.* at 41a).[3]

The principal, initial beneficiaries of this price differential were the Aramco participants, through which the Saudi government continued to market its crude oil supplies. Between 1979 and 1981, Saudi Arabia sold crude oil to these companies—including respondent—at prices below those generally available in the world market (*id.* at 3a). See note 6, *infra*. This price differential became widely known as the "Aramco advantage" (App. 67a).

b. In an effort to allow the oil consuming nations—rather than the Aramco participants alone—to benefit from the below-market Saudi crude oil price, Saudi Oil Minister Ahmed Zaki Yamani wrote a letter in 1979 to the Chairman of the Board of Aramco. This letter, which is referred to in the opinions below as "Letter 103/Z," informed the Chairman that any future sales of Saudi crude to Aramco were to be conditioned upon a "pledge" by the Aramco participants "that they will not sell [Saudi crude oil] to a third party at prices in excess of" the Saudi official selling price (App. 3a n.2).[4] This resale price restric-

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[3] Saudi crude oil price increases lagged somewhat behind the OPEC price increases during this period, but the Saudi price increases were nonetheless substantial. The price of Saudi crude, which was $13.34 per barrel in January 1979, rose to $34.00 per barrel by October 1981. App. 66a.

[4] Although the letter by its plain language applied only to sales to "third parties," thereby implying that it applied only to

tion remained in effect from January 1979 through October 1981 (*id.* at 67a).

The restriction described in Letter 103/Z, however, "applied only to Saudi crude, not to the sale of products refined from Saudi crude" (App. 4a). As a result, the Aramco participants—including respondent—"earned large profits from the sale of refined products" (*ibid.*). The Saudi Oil Minister who wrote Letter 103/Z stated publicly that "I cannot do anything after [the Saudi crude is purchased] if Exxon, Mobil or any of the four [Aramco participants] sell their refined products in the market at the market price which enables them to realize a higher rate of profit than is usually realized by other refiners. *That is in their pocket; I cannot interfere.*" App. 46a (emphasis added).[5]

Part of the profits thus placed in the "pocket" of the Aramco participants during the 1979-1981 period was the profit earned by their foreign and domestic affiliates who refined the crude oil purchased at the low Saudi price and sold the refined products at the market price for those products—thus earning "a higher rate of profit than is usually realized by other refiners" (App. 46a). In this manner, the foreign and domestic refining affiliates of respondent (and the other Aramco participants) reaped the economic value of the "Aramco advantage." The vast majority of the Saudi crude oil purchased by respondent during this

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sales to unrelated entities, the Tax Court found that the restriction applied also to sales to affiliated entities. App. 133a.

[5] The Saudi Oil Minister further stated that "the oil companies are definitely making much higher profits in the downstream by refining Saudi crude and selling the products at higher prices. *This we cannot control.*" App. 48a (emphasis added).

period was transferred to its affiliated foreign and domestic refiners at the below-market Aramco price. Only approximately 20 percent was sold to non-affiliated customers (*id.* at 23a-24a).[6]

Throughout the period following 1976, when the Saudi government assumed ownership of the producing assets of Aramco, the Aramco participants had no obligation to purchase Saudi crude oil. As the Chairman of Exxon testified, the resale price condition imposed by Letter 103/Z was simply a "condition[] of sale" and Exxon "always had the choice of not buying Mr. Yamani's oil" (Tr. 154-155). As he testified, "[a]ny purchaser has a right to take it or not, if [he] doesn't want to meet the conditions" (Tr. 155). The Aramco participants continued to purchase the Saudi production during 1979-1981 because of their obvious economic interest in obtaining crude oil supplies for their world-wide refining and distributing operations. However, when the price of Saudi crude increased *above* the world market price in 1982—and the "Aramco advantage" turned into an "Aramco disadvantage"—the Aramco participants drastically cur-

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[6] Texaco International Trader, Inc. (Textrad) was the domestic subsidiary through which respondent made international purchases and sales of crude oil. Between January 1979 and June 1981, Textrad purchased 1.9 billion barrels of Saudi crude oil through Aramco. Textrad sold 34.2 percent of this Saudi crude oil to other affiliates of respondent and 21.7 percent of the oil to Caltex Petroleum Company, a corporation owned jointly by respondent and Chevron. Textrad sold less than 20 percent of its Saudi crude oil during this period through direct sales to unaffiliated third parties (App. 23a-24a).

tailed their purchases of crude oil from Saudi Arabia (App. 67a).[7]

2. Under Section 482 of the Internal Revenue Code, when two or more organizations are "owned or controlled directly or indirectly by the same interests," the Commissioner of Internal Revenue may "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations * * * if he determines that such * * * is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations." 26 U.S.C. 482. The Commissioner determined in this case that, in order clearly to reflect the income of respondent for the years 1979-1981, it was necessary to allocate approximately $1.8 billion of income to respondent that had been realized through the sale of refined products by its foreign affiliated refineries. This is the amount of additional income that respondent would have received if it had sold the Saudi crude oil to its foreign affiliated refineries at its true economic value, rather than at the stipulated Saudi price (App. 98a).

The Commissioner's reallocation of this income increased respondent's federal income tax liability because the income of the foreign affiliates of respondent is not directly subject to United States tax. Without this reallocation, the income earned by

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[7] For example, as the Saudi price increased above the world market price after 1981, the purchases of Saudi crude by Exxon fell from 2,000,000 barrels per day in 1981 to 600,000 barrels per day in 1983. The purchases by respondent declined from 2,000,000 barrels per day in 1981 to 1,000,000 barrels per day in 1982. App. 67a. The Chairman of Exxon testified that, when the Saudi price rose above the world price in 1982, the oil companies simply "decided not to take it" (Tr. 155).

the activities of respondent that was diverted to respondent's foreign affiliates through favorable pricing arrangements would escape direct United States taxation. It was the marketing activities of respondent, not the refining activities of its affiliates, that earned that income. And, as the Saudi government contemplated, that income ended up in respondent's "pocket" (App. 46a) in the "downstream" accounts of its controlled foreign affiliates (*id.* at 48a). The Commissioner determined that it was necessary to reallocate such income to respondent from its foreign affiliates in order more "clearly to reflect" respondent's income under Section 482.

3. Respondent challenged the Commissioner's determination in Tax Court. Respondent's suit was consolidated with a similar case involving Exxon. Following an evidentiary hearing, the Tax Court held in favor of respondent and Exxon.[8]

The Tax Court reasoned that the resale price restriction contained in Letter 103/Z from the Saudi Oil Minister was the "virtual equivalent" of a law prohib-

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[8] The Commissioner had issued a similar notice of deficiency to Exxon based upon a reallocation of approximately $4.5 billion of income to Exxon from its foreign affiliated refining companies for the years 1979-1981 (App. 99a-100a). As in respondent's case, this income was realized by Exxon's foreign affiliates through their reaping of the economic benefit of the "Aramco advantage" that had been passed to them by Exxon's domestic marketing subsidiary (*ibid.*).

The decision of the Tax Court in this case was favorable to Exxon as well as to Texaco (App. 187a). Because other, unrelated tax issues remain pending in the Exxon case, however, a final decision has not been entered in that case. Any appeal from a final order in the Exxon case would lie to the Second Circuit.

iting respondent from selling Saudi crude oil at a price greater than the Saudi price (App. 5a). Although the Saudi government contemplated that respondent would pocket the associated income through its "downstream" uses of the oil, the court concluded that the "virtual" Saudi law barred respondent from receiving the "Aramco advantage" profits that the Commissioner sought to allocate to it (*id.* at 99a). Relying on this Court's decision in *Commissioner* v. *First Security Bank*, 405 U.S. 394 (1972), the Tax Court held that, when any law prohibits a taxpayer from receiving a particular item of income, the Commissioner is precluded from allocating such income to the taxpayer under Section 482. According to the Tax Court, it did not matter (i) that respondent had consented to the Saudi condition by purchasing crude oil subject to the price restriction, (ii) that respondent had *directly* realized much of the "Armaco advantage" profits through the activities of its *domestic* refinining affiliates or (iii) that neither criminal nor civil penalties had been established by the Saudi government for any violation of the resale price restriction. The court held that it was enough that, if the restriction had not been adhered to by respondent, the "dire consequences of reduced [oil] supplies or worse" would have occurred (405 U.S. at 100-101).

4. The court of appeals affirmed (App. 1a-13a). The court agreed with the Tax Court that Letter 103/Z "had the effect of a legal restriction in Saudi Arabia" (*id.* at 6a). The court of appeals similarly agreed with the Tax Court that, "[b]ecause the sales price of the crude is governed by Letter 103/z, Texaco did not have the power to control the sales price of the oil" (*ibid.*). The court of appeals stated that, under this Court's decision in *First Security Bank*, the Com-

missioner could reallocate the Aramco advantage profits under Section 482 only if respondent had "'complete power' to shift income among its subsidiaries" (App. 8a, quoting *Commissioner* v. *First Security Bank*, 405 U.S. at 404-405). The court stated that respondent lacked "precisely this ability to control the flow of its income" because "Letter 103/z had the force and effect of law" and respondent "was obligated to comply with its requirements, and * * * did so" (App. 10a).

The court of appeals rejected the Commissioner's argument that this case differed from *First Security Bank* because the "law" involved in this case did not preclude respondent from receiving the income that is the subject of the tax; instead, the foreign "law" only required respondent to realize these profits in its "downstream" operations. The Saudi government had no objection to the actions taken by respondent to put (and keep) the profits in its "pocket" (App. 46a). The Commissioner contended that these differences brought this case within the scope of *United States* v. *Basye*, 410 U.S. 441 (1973), in which this Court held that *First Security Bank* did not apply in the case of a distortion of income resulting from a "consensual agreement of two parties acting at arm's length." *Id.* at 453 n.13. The court of appeals stated, however, that the analysis of *Basye* does not apply to this case because, in light of "the severe economic reprisal that would have flowed from * * * a violation" of Letter 103/Z, respondent was deprived "of the power to sell Saudi crude to its foreign refining affiliates for a price that exceeded" the Saudi price (App. 12a, 13a).

REASONS FOR GRANTING THE PETITION

This case presents an issue of exceptional fiscal and administrative importance. The decision of the court of appeals ignores "the first principle of income taxation: that income must be taxed to him who earns it." *Commissioner* v. *Culbertson*, 337 U.S. 733, 739-740 (1949). By ignoring this "foundational rule" of income taxation (*United States* v. *Basye*, 410 U.S. 441, 449 (1973)), the decision of the court of appeals misapplies this Court's decision in *Commissioner* v. *First Security Bank*, 405 U.S. 394 (1972), and fails to adhere to the holding of this Court in *United States* v. *Basye*, 410 U.S. at 453 n.13, that a "consensual agreement" cannot prevent a reallocation by the Commissioner more "clearly to reflect" a taxpayer's income under Section 482.

More than $1,000,000,000 of taxes are at stake in this case. More than twice as much is involved in the companion case involving Exxon. See note 8, *supra*. The decision of the court of appeals threatens similarly broad and recurring consequences for other taxpayers, for it offers a blueprint for the evasion of United States taxes through the application of "legal restrictions" that channel the profits earned by United States taxpayers into the accounts of their foreign affiliates.

Review by this Court of the decision in this case is warranted by the exceptional fiscal and administrative importance of the question presented and by the serious misapplication by the court of appeals of the decisions of this Court.

1. a. Section 482 of the Internal Revenue Code authorizes the Commissioner to allocate income or deductions among commonly controlled businesses "if

he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such * * * businesses." 26 U.S.C. 482. This statute was first enacted as Section 45 of the Revenue Act of 1928, ch. 852, 45 Stat. 806. It has long served as "one of the Service's principal weapons for policing the fairness of transactions between related enterprises * * * that cannot or do not file consolidated returns." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 15.03, at 15-14 (1987 ed.). As Professors Bittker and Eustice have noted (*ibid.*) (emphasis supplied):

> The major function of §482 is the prevention of artificial shifting, milking, or distorting of the true taxable incomes of commonly controlled enterprises, but *its concern is with economic reality rather than the taxpayer's motivation or purpose.*

The Treasury regulations promulgated under this statute have long explained that "[t]he purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer." 26 C.F.R. 1.482-1(b) (1981). See also note 1, *supra*.

In this case, in an effort to detemine "the true taxable income from the property and business" of respondent, the Commissioner concluded that it was necessary to allocate to respondent the income earned through its marketing of Saudi crude when the economic value of that income had been realized by respondent's affiliates—by their enjoyment of the

below-market-price inventories of crude oil obtained from respondent. The Commissioner's determination did not "create" any income; nor did it attribute income to respondent that respondent had not already enjoyed, for respondent has complete control over its foreign affiliates. The Commissioner's determination simply placed this income in the "pocket" of the taxpayer whose economic activities earned it. By doing so, the Commissioner followed "the first principle of taxation: that income must be taxed to him who earns it." *United States* v. *Basye*, 410 U.S. at 449, quoting *Commissioner* v. *Culbertson*, 337 U.S. at 739-740.

2. The court of appeals held, however, that the Commissioner's determination was invalid. The court did not doubt that, as a matter of "economic reality" (B. Bittker & J. Eustice, *supra*, at 15-14), the income at issue in this case was attributable to the activities of respondent. Instead, the court reasoned (i) that the resale price restriction on Saudi crude oil contained in Letter 103/Z was the "equivalent" of a foreign law that prohibited respondent from receiving this income (App. 5a) and (ii) that such income therefore could not be allocated to respondent because, in *Commissioner* v. *First Security Bank*, *supra*, "the Court held that § 482 did not authorize the Commissioner to allocate income to a party prohibited by law from receiving it" (App. 7a). Neither leg of the court's reasoning withstands scrutiny.

a. The Saudi price "restriction" did not purport to deprive respondent of the right to receive this income. To the contrary, the Saudi Oil Minister expressly contemplated that this income would be received in the "downstream" operations of respondent's refining affiliates (whether foreign or domestic) and would thus remain in respondent's "pocket" (App. 46a). The

Saudi "restriction" was not a restriction against receiving income; it was a restriction on the *method* by which respondent was to receive this income. As the Saudi Oil Minister stated, it was fully anticipated that the Aramco participants would be "making higher profits in the downstream by refining Saudi crude and selling the products at higher prices" and "*[t]his we cannot control*" (*id.* at 48a) (emphasis added). Because the Saudi government had no objection to the actions taken by respondent to obtain and retain these profits (*ibid.*), the court of appeals manifestly misapplied the holding of *First Security Bank* in stating that respondent was "prohibited by law from receiving" this income (App. 7a).[9]

b. Moreover, the court of appeals fundamentally erred in its intepretation of the holdings of this Court in *First Security Bank* and *Bayse*. The court of appeals broadly reasoned that, under *First Security Bank*, any legal restriction that deprives the taxpayer of the "'complete power' to shift income among its subsidiaries" prevents the Commissioner from reallocating such income to the taxpayer (App. 8a,

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[9] For example, in respondent's federal income tax returns for 1979-1981, it consolidated with its own income the income that its *domestic* refining affiliates enjoyed from their receipt of the fruits of the "Aramco advantage." No suggestion has been made that such a consolidation of respondent's domestic income for domestic tax purposes violated the Saudi "law." Respondent could not realistically contend that a similar allocation to respondent—for purposes of United States taxation under Section 482 of the Internal Revenue Code—of this *same* "Aramco advantage" income received by respondent's *foreign* refining affiliates would place respondent in violation of any Saudi "law" or bring down upon it any "severe economic reprisal" (App. 13a) from the Saudi government.

quoting *Commissioner* v. *First Security Bank*, 405 U.S. at 404-405, quoting 26 C.F.R. 1.482-1(b)(1) (1971)). That description of the holding of *First Security Bank* ignores the factual context and the reasoning of the decision in that case; it also fails to give account to the subsequent decision of this Court in *Basye*, which distinguished *First Security Bank* on grounds that are controlling in this case.

Commissioner v. *First Security Bank* involved a rare factual situation. In that case, the Commissioner sought to allocate income to a bank from an insurance affiliate even though the bank was not lawfully able to engage in the type of business (insurance) from which the income at issue was earned. 405 U.S. at 401-402. The Court noted that federal law prohibited the bank from engaging in the enterprise that generated the income and that "[t]he penalties for violation of the banking laws include possible forfeiture of a bank's franchise and personal liability of directors." *Ibid.* It was in this narrow factual context—where the taxpayer could not lawfully engage in the commerce that produced the income—that the Court stated that the Commissioner could not allocate income to the taxpayer because the taxpayer lacked "'complete power' to shift income among its subsidiaries." *Id.* at 404.

In the present case, by contrast, respondent was lawfully engaged in the business of buying and selling crude oil. Moreover, the price "restriction" that was imposed on the supplies that respondent purchased from Saudi Arabia in 1979-1981 did not prohibit respondent from receiving the income attributable to those advantageous purachases. The Saudi Oil Minister publicly stated that the Saudi government had no concern about the fact that respondent would ulti-

mately "pocket" these profits from its refining operations (App. 46a). No legal or practical disability prevented respondent from earning—or from receiving into the accounts of its family of controlled affiliates—the income involved in this case.[10] See note 9, *supra*.

As this Court explained in *United States* v. *Basye*, 410 U.S. 441 (1973), the holding in *First Security Bank* does not apply when the deflection of income from the taxpayer to one of its controlled affiliates is pursuant to a consensual arrangement rather than necessitated by a legal disability to engage in such commerce. In *Basye*, the Court explained that "[t]he entity earning the income * * * cannot avoid taxation by entering into a contractual arrangment whereby that income is diverted to some other person or entity." 410 U.S. at 449. That holding applies directly to the present case for, as the Exxon Chairman acknowledged, the Aramco participants had no obligation to purchase Saudi crude; the purchases were consensual. See page 7 & note 7, *supra*.

The distinction between *First Security Bank* and *Basye* is that, (i) in the former case, the taxpayer

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[10] In *Procter & Gamble Co.* v. *Commissioner*, 961 F.2d 1255 (6th Cir. 1992), the court of appeals held that *First Security Bank* applies where the law prohibiting the receipt of income is that of a foreign country. See *id.* at 1259 ("[w]e see no reason to alter [the analysis of *First Security Bank*] because foreign law, as opposed to federal law, prevented payment of royalties"). The Commissioner disagrees with that aspect of the holding in *Proctor & Gamble*. See Rev. Rul. 82-80, 1982-1 C.B. 89 ("when the prohibition on the receipt of income is based not on the laws of the United States * * * , the decision in *First Security Bank of Utah* does not foreclose the Service from applying Section 482 in order to clearly reflect income").

inherently lacked the "power" to allocate income among its subsidiaries because one of them could not lawfully conduct the relevant business whereas, (ii) in the latter case, the taxpayer merely *surrendered* the "power" directly to receive the income under the terms of a consensual commercial arrangement. In the present case, however, the court of appeals focussed only on the fact that, *after* respondent agreed to purchase the Saudi oil, it was bound by the Saudi restriction. The court neglected to consider the dispositive point under *Bayse* that respondent, as a United States taxpayer, "cannot avoid [United States] taxation" by *consenting* to purchases of oil subject to the Saudi restriction and thereby "divert [such income] to some other person or entity." *United States* v. *Bayse*, 410 U.S. at 449.

c. It bears emphasis that, by conforming to the Saudi price "restriction," respondent reaped enormous profits. The Saudi government had no obligation to sell its crude oil to respondent at below-market prices. The "Aramco advantage" was a commercial windfall that permitted respondent to realize billions of dollars of extra profit by marketing this oil through its controlled affilliates. It is those profits, and nothing else, that are at issue in this case. It is, moreover, simply fanciful for respondent to contend that it was coerced by economic necessity into the Saudi price restriction. Respondent profited enormously from the Saudi price advantage and, as the Saudi government anticipated, was allowed to pocket these profits in the accounts of its controlled refining subsidiaries.

The Commissioner's determination seeks only to tax to respondent the economic values that it earned

from the economic activity that it conducted.[11] Under Section 482, the Commissioner properly allocated the income involved in this case to the entity whose activities "earn[ed] it" (*United States* v. *Bayse*, 410 U.S. at 449). The guiding principle in adjustments made under Section 482 "clearly to reflect income" is "economic reality" (B. Bittker & J. Eustice, *supra*, at 15-14). It is a fundamental objective of the statute "to correct artificial intragroup pricing policies" that shift income "to affiliated foreign corporations that are not generally subject to U.S. tax" (*id.* at 15-16). The taxpayer's "motivation or purpose" in entering into the arrangment is not relevant (*id.* at 15-14). A reallocation is necessary clearly to reflect the taxpayer's income when, as here, the taxpayer's activities have earned income that has been realized by a foreign affiliate that the taxpayer controls—for income is to be taxed "to him who earns it."

3. That the Saudi resale price restriction represents a consensual, commercial arrangement, as opposed to a "law" enacted by a foreign "sovereign," finds support not only in the facts of this case (pages 7-8, *supra*) but also in a long and consistent line of decisions of this Court concerning governmental

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[11] Section 482 authorizes reallocation of the income earned by the commercial activities of a United States corporation solely for the purposes of the tax laws of the United States. Application of Section 482 in this case does not interfere with the Saudi price restriction. Respondent resold the Saudi crude to its affiliates at the price it purchased it; that was its only undertaking. The Saudi government did not seek to control the ultimate profit realized by respondent in its sale of refined products (App. 48a) ("This we cannot control.").

immunity.[12] The Court has repeatedly held that, when a government undertakes a commercial activity, it acts in a commercial, not sovereign, capacity. In *Bank of the United States* v. *Planters' Bank of Georgia*, 22 U.S. (9 Wheat.) 904, 907 (1824), the Court explained:

> It is, we think, a sound principle that when a government becomes a partner in any trading company, it divests itself, so far as concerns the transactions of that company, of its sovereign character, and takes that of a private citizen. Instead of communicating to the company its privileges and its prerogatives, it descends to a level with those with whom it associates itself, and takes the character which belongs to its associates, and to the business which is to be transacted.

This principle is equally applicable to domestic and foreign governments that elect to act in a commercial capacity. See, *e.g.*, *Ohio* v. *Helvering*, 292 U.S. 360, 369 (1934) ("If a state chooses to go into the business of buying and selling commodities, its right to do so may be conceded so far as the Federal Constitution is concerned; but the exercise of the right is not the performance of a governmental function * * *. When

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[12] The court of appeals erred in implying that whether the resale price restriction in Letter 103/Z was a Saudi "law" was a question of fact to be reviewed under the clearly erroneous standard (App. 6a). It has long been settled that a trial court's determination of foreign law "shall be treated as a ruling on a question of law." Fed. R. Civ. P. 44.1. See *Kalmich* v. *Bruno*, 553 F.2d 549, 552 (7th Cir.), cert. denied, 434 U.S. 940 (1977); *Bassis* v. *Universal Line, S.A.*, 436 F.2d 64, 68 (2d Cir. 1970); *Bamberger* v. *Clark*, 390 F.2d 485, 488 (D.C. Cir. 1968).

a state enters the market place seeking customers it divests itself of its *quasi* sovereignty *pro tanto*, and takes on the character of a trader."); *South Carolina* v. *United States*, 199 U.S. 437, 463 (1905) (same).

The Court has recently applied this principle in a case interpreting the proper scope of the immunity of a foreign government from suit. In *Republic of Argentina* v. *Weltover, Inc.*, 504 U.S. 607 (1992), the Argentine government had issued bonds as part of a plan to stabilize its currency. Bondholders were entitled to repayment in U.S. dollars. The Argentine government, however, lacked sufficient foreign exchange to retire the bonds as they came due. The government therefore unilaterally extended the time for payment. When the bondholders brought suit in a federal district court, Argentina sought to have the suit dismissed on the ground that it was immune from suit in the courts of the United States.

The threshold issue was whether the issuance of the bonds by Argentina was a "commercial activity" within the meaning of the Foreign Sovereign Immunities Act of 1976 (FSIA), 28 U.S.C. 1602 *et seq.* In holding that it was, the Court adhered to the analysis it has applied since its decision in *Planters' Bank* in 1824. The Court held that, "when a foreign government acts, not as regulator of a market, but in the manner of a private player within it, the foreign sovereign's actions are 'commercial' within the meaning of the FSIA." 504 U.S. at 614. The Court explained that in such cases "the issue is whether the particular actions that the foreign state performs (whatever the motive behind them) are the *type* of actions by which a private party engages in 'trade and traffic or commerce.'" *Ibid.*, quoting *Black's Law Dictionary* 270 (6th ed. 1990). The Court noted that a

"sales contract" is an example of the situation in which a foreign Nation acts in a commercial, rather than sovereign, capacity (504 U.S. at 614-615):

> Thus, a foreign government's issuance of regulations limiting foreign currency exchange is a sovereign activity, because such authoritative control of commerce cannot be exercised by a private party; whereas a contract to buy army boots or even bullets is a "commercial" activity, because private companies can similarly use sales contracts to acquire goods.

The principle articulated by the Court in these decisions applies directly to the commercial sales arrangements under which Saudi crude oil was sold to respondent and the other Aramco participants during the period relevant to the present case.[13] The court of appeals erred in reasoning (App. 6a) that the resale price component of this commercial arrangement

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[13] The fact that the Saudi government acts in a commercial, rather than sovereign, capacity in effecting sales of crude oil has been recognized in arbitration proceedings involving Saudi Arabia and Aramco. *Saudi Arabia* v. *Arabian American Oil Co.*, 27 I.L.R. 117 (1958). In that case, Saudi Arabia had granted to Aristotle Onassis, in an agreement ratified by royal decree, the exclusive right to ship crude oil from Saudi Arabia. The Saudi government contended that the grant to Onassis constituted a law that Aramco was obligated to obey by delivering to Onassis, in Saudi Arabia, all the Saudi crude oil that Aramco lifted. *Id.* at 140. The arbitration tribunal found, however, that the Onassis agreement was "neither a Law of the State of Saudi Arabia nor a Governmental regulation." *Id.* at 228. Critical to the tribunal's finding was that the agreement had "a purely contractual nature" and did not "lay down the norms of a general and impersonal nature." *Id.* at 204.

nonetheless became a sovereign "law" because it was announced with the implicit approval of the Saudi King. In *Republic of Argentina* v. *Weltover, Inc.*, 504 U.S. at 616, the Argentine government had changed the payment terms of its bonds to protect its foreign exchange program and to avert a domestic credit crisis. These obviously were legitimate governmental concerns. But the underlying activity in that case, as here, was an inherently commercial one. See *ibid.* The Court held in *Weltover* that, even if the underlying concerns were governmental in nature, that would not convert a commercial act into a sovereign one. *Id.* at 614 ("whatever the motive behind them"). See also *South Carolina* v. *United States*, 199 U.S. at 463 (a State's activity in selling liquor is a commercial act even though undertaken pursuant to validly enacted law).

The court of appeals also erred in concluding that the Saudi condition of sale was the "virtual equivalent" of a "law" simply because respondent could have faced "severe" economic repercussions if it failed to adhere to the resale price restriction (App. 13a). The fact that the Aramco participants, during the period from 1979 to 1981, had little leverage in their purchases of Saudi crude stemmed from the substantial market power that large sellers of crude oil had in those years. It does not differentiate this case from any other commercial relationship in which a buyer becomes dependent largely on one source of supply. Indeed, when the market relationship evolved again in 1982—and the "Aramco advantage" became an "Aramco disadvantage"—respondent and the other Aramco participants severely reduced their purchases of oil from Saudi Arabia. See pages 7-8 & note 7, *supra*. The fact that market conditions temporar-

ily allowed Saudi Arabia to "dictate" the terms of the commercial sale of its product does not make those terms a "law." Nor does it distinguish this case from any other in which the ordinary ebb and flow of market conditions alters the balance of power in commercial relationships.

Furthermore, in concluding that the Saudi condition was a "law" because the threat of "severe economic reprisal" left respondent with no real choice (App. 13a), the court of appeals plainly misperceived the economic forces at work. There is no plausible reason why respondent should have desired to stem the flow of Saudi largess, which showered billions of dollars of extra profits on it through the benefits of the "Aramco advantage." Respondent stood to realize, and did realize, an enormous windfall from the terms under which the Saudi Oil Minister sold crude oil during that era. It is unrealistic to think that a corporation that stood to benefit so enormously would object merely because those profits were to be realized by its domestic and foreign refining affiliates, rather than by its marketing subsidiary. In either event, the profits ended up, as planned, in respondent's corporate "pocket."

The Commissioner's determination to allocate those profits, and tax them, to the entity that earned them is directly supported by this Court's decision in *United States* v. *Basye*, 410 U.S. at 449. The decision of the courts below fundamentally misinterprets and misapplies *Basye* and *First Security Bank* by permitting a consensual, foreign directive to control—and distort—the application of United States tax law.

6. The decision in this case has enormous importance to the public fisc, both immediately and prospectively. Including the interest that has accumulated

on the unpaid taxes, more than $5,000,000,000 is at stake in this case and the similar case involving Exxon. The Exxon case remains pending in the Tax Court and ultimately will be appealable to the Second Circuit. See note 8, *supra*. If that court were hereafter to rule in the Commissioner's favor on this issue, and thereby create a direct conflict on the precise question presented, the United States would not then be able to recover the taxes in excess of $1,000,000,000 involved in this case. The massive revenue impact of the two cases combined reflects the inherent importance of the question presented.

The analysis applied by the court of appeals in this case threatens a serious and recurring prospective injury to the public fisc. In the modern business environment, with most large United States corporations conducting business internationally, and with many foreign governments participating directly in commercial activities with multi-national corporations, it is not difficult to perceive the consequences of the reasoning applied in this case. The decision of the court of appeals creates substantial tax incentives for United States corporations to encourage or endure the adoption of profitable foreign "legal restrictions" that "require" such corporations to avoid United States taxation on income earned by their activities by diverting those profits to their controlled foreign subsidiaries.[14]

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[14] This case presents a textbook example of the advantages that a United States corporation can derive from being "thrown into the briar bush" by a foreign "legal restriction." The Saudi "legal restriction" poured extensive profits into respondent's accounts and also gave it a basis for contending that a portion of those profits is immune from United States tax. The decision of the courts below offers taxpayers (and foreign Nations)

In the Commissioner's view, it is "economic reality" (B. Bittker & J. Eustice, *supra*, at 15-14), not the commercial preferences of foreign Nations, that controls the United States tax liability of United States taxpayers under Section 482 of the Internal Revenue Code. The question whether a foreign government can, in a commercial arrangement, dictate the United States tax consequences of income earned abroad by a United States taxpayer is a question of substantial, recurring importance that this Court should resolve.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General
LORETTA C. ARGRETT
Assistant Attorney General
LAWRENCE G. WALLACE
Deputy Solicitor General
KENT L. JONES
Assistant to the Solicitor General
JONATHAN S. COHEN
THOMAS J. CLARK
Attorneys

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a substantial incentive to consent to "legal restrictions" that "require" the earnings of United States corporations to be retained (and thus sheltered) in the accounts of controlled foreign affiliates.